Junior-Subordinated Capital Securities Markets

June 2019 Updates

The bond market continued its very firm move to lower yields aided by a significant downward shift of the US Treasury yield curve, but a "stubborn" inversion on the front end still prevails. The rates move extended the trend to lower yields all month long and (after last month's rally) has now matched one of its longest rallies since 4q18 (i.e., Powell policy exuberance & blunders), 1q16 (i.e., oil price capitulation & global equity implosion) and 4q14 (i.e., Greek politics & ECB QE) – each lasting roughly two months before finally consolidating after some sort of central bank policy response. The 30yr US Treasury bond closed the month yielding 2.53% (5bps lower MTD; and 48bps lower since the end of 2015, which was the time of Fed's 1st move up on rates). The US Treasury 10yr note closed yielding 2.00% (14bps lower MTD; and 27bps lower since the end of 2015). The yield differential between these two longer US Treasury terms closed at 53bps (20bps steeper on the year). The equity market cheered the Fed's dovishness by setting new highs in June just after finishing one of its worse months of the expansion (declining 6.6% from the highs in May) – the S&P 500 closed up 6.9% at 2942 as trade tensions eased going into the G-20 Summit.

Last month we reiterated Chairman Powell's concerns that the lack of inflation (or in other words, the risk of deflation) is "one of the greatest challenges of our time" – this perturbation is becoming an economic enigma. The concept of an "insurance cut" in rates is the latest talking point from Fed governors to address the puzzle and the bond market's concerns over persistently muted inflation. Indeed, central banks are still struggling with how to flame inflation and the conundrum has fanned Fed members with growing uncertainties to the economic outlook in the face of collapsing yields along the treasury term structure. Central banks appear captive to markets rather than markets captive to central banks. In order for the system to "keep the faith" (which is paramount to any debt-backed fiat currency), central banks are forced to convince markets that they have all the policy tools necessary to "sustain the expansion" and will "do whatever it takes" to save the currency. From the perspective of the US Federal Reserve Bank, its dual mandate of fostering maximum employment and price stability has been met – but, the worry is primarily on future price instability (i.e., the risk of falling prices not just in the US, but in Europe too). Indeed, the Fed has committed to closely monitor the incoming data and its implication with a much more reactive policy mindset than the patient one, heretofore. The difference in Fed messaging from earlier this year it that the Fed now indicates a clear willingness to move and the markets (after forcing the Fed react) appear satisfied with the pivot. The next question is "When?" – and what circumstances impel "when" to happen.

Our view had been that the Fed would stand still throughout the summertime because it has been successful at resurging equities with rhetorical pivot rather than actual follow through. The rates market appears quite zealous in demanding 3 rate cuts this year despite equities having fully recovered from its deepest correction since the sovereign debt crisis. The fact that equities have recovered so remarkably is testament to the Fed having a critical third mandate "to prolong the current expansion" in order to feel sanguine on price stability. So, the idea of an insurance cut in rates of 25-50bps in July can become justified by mandate in a way that can adroitly appease President Trump's tweets about Chairman Powell to "stop behaving like a stubborn child…and cut rates". So, the Fed will very likely move rates down in July, but likely not before an ECB move first in mid-month. Europe after all, appears to be the weakest link of the global central bank policy chain -- the key of course, is to not break the chain.

Before we discuss performance in capital securities this month, let's look at performance in some other credit markets for reference points on returns and yield changes before the month-end rebalancings:

- The junk market (measured by the ICE Bank of America Merrill Lynch High Yield ***h0a0*** index) rose 2.45% to close yielding 6.04% (71bps lower).
- Financial credit (measured by ICE Bank of America Merrill Lynch's ***cf06*** index) rose 2.45% to close yielding 3.16% (35bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE Bank of America Merrill Lynch's ***c6a4*** index) rose 2.36% to close yielding 3.44% (34bps lower).

Review of Market Structure:

The market for **global junior-subordinated capital securities** (*i.e.,* "**Jsubs**") is comprised of:

1. Preferred Securities, and
2. Contingent Capital Securities

Each sector is evolving with unique technical, structural and fundamental features that are discussed and updated below:

Global junior subordinated capital securities are comprised of two sub-sets that represent a broad group of global junior-subordinated capital securities, which can be referenced by two ICE Bank of America Merrill Lynch indexes: 1) The ICE BofA Merrill Lynch US All Capital Securities Index (***i0cs***) and 2) The ICE BofA Merrill Lynch Large Cap Contingent Capital Index (***cocl***).

Our litmus test for junior-subordinated capital securities satisfies two core characteristics:

1) any non-payment of distributions would not accelerate an event of default (i.e., distributions are "junior-subordinated" to ordinary interest obligations) and,

2) balance sheet classification is something other than common stock under GAAP disclosure.

The US All Capital Securities (***i0cs***) benchmark of preferred securities represents $297.4 billion (face amount) of investment grade and below investment grade instruments in both the retail $25par market (44%) and the institutional $1,000par market (56%). The Contingent Capital (***cocl***) benchmark of junior-subordinated capital securities represents $216.0 billion (face amount) of investment grade and below investment grade fixed-rate instruments with contractual triggers that could subordinate them to common stock in a reorganization that does not fall into a receivership. These two benchmarks combine for a $513.4 billion universe of fixed-rate junior-subordinated capital securities with preferred securities (measured by ***iocs***) being a 58% subset and contingent capital securities (measured by ***cocl)*** being 42% subset of the total global junior subordinated group.

Preferred Securities

In the preferred securities sleeve, there are four sub-component indexes in the US All Capital Securities Index (***i0cs)*** – this entire index is comprised of global "preferred securities". A **"preferred security"** can represent a capital security issued either through charter amendment (i.e., as a stock) or through indenture (i.e., as a bond) typically within the context of a "gone-concern" statutory authority (*e.g.,* US banks). As a gone concern, a company reorganization would be processed through a bankruptcy court. Preferred security payments are in priority to common stock dividends, yet can be deferred (i.e., payments are cumulative) or eliminated (i.e., payments are non-cumulative) without causing an immediate event of default; any principal loss absorption on a preferred security would be forced only *ex-post* through a statutory resolution in a bankruptcy proceeding.

The four sub-components of the *i0cs* preferred securities benchmark are:

1. **ICE BofAML Fixed Rate Preferred Index (*p0p1*) @ 45% *of i0cs***
  - Comprised of IG $25par and IG $1,000par US AT1
    - The *p0p1* rose 1.38% this month to close yielding 2.95%

- ❖ The rebalancing this month increased headcount by 2, and face value by $1.4 billion

2. **ICE BofAML High Yield Fixed Rate Preferred Index (*p0hy*) @ 24% of *i0cs***
    - <u>Comprised of BIG $1,000par US AT1 and BIG $25par</u>
        - ❖ The *p0hy* rose 1.41% this month to close yielding 4.27%
        - ❖ The rebalancing had no impact on headcount, but face value declined by $359 million
3. **ICE BofAML US Capital Securities Index (*c0cs*) @ 25% of *i0cs***
    - <u>Comprised of dated IG $1,000par hybrids (no US AT1)</u>
        - ❖ The *c0cs* rose 2.40% this month to close yielding 4.37%
        - ❖ The rebalancing increased headcount by 3, and face value by 2.1 billion
4. **ICE BofAML High-Yield Capital Securities Index (*h0c*s) @ 5% of *i0cs***
    - <u>Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids</u>
        - ❖ The *h0cs* rose 1.90% this month to close yielding 5.49%
        - ❖ The rebalancing cut headcount by 2, and reduced face value by $1.1 billion

Overall, the BofAML All US Capital Securities Index (***i0cs***) rose 1.70% in June to close yielding 3.80%, which was 48bps lower than last month's closing yield and a spread of +190bps over comparable US Treasury securities (27bps lower). The yield impact from the rebalancing increased the yield-to-worst by 5bps to 3.85%.

<u>Contingent Capital Securities</u>

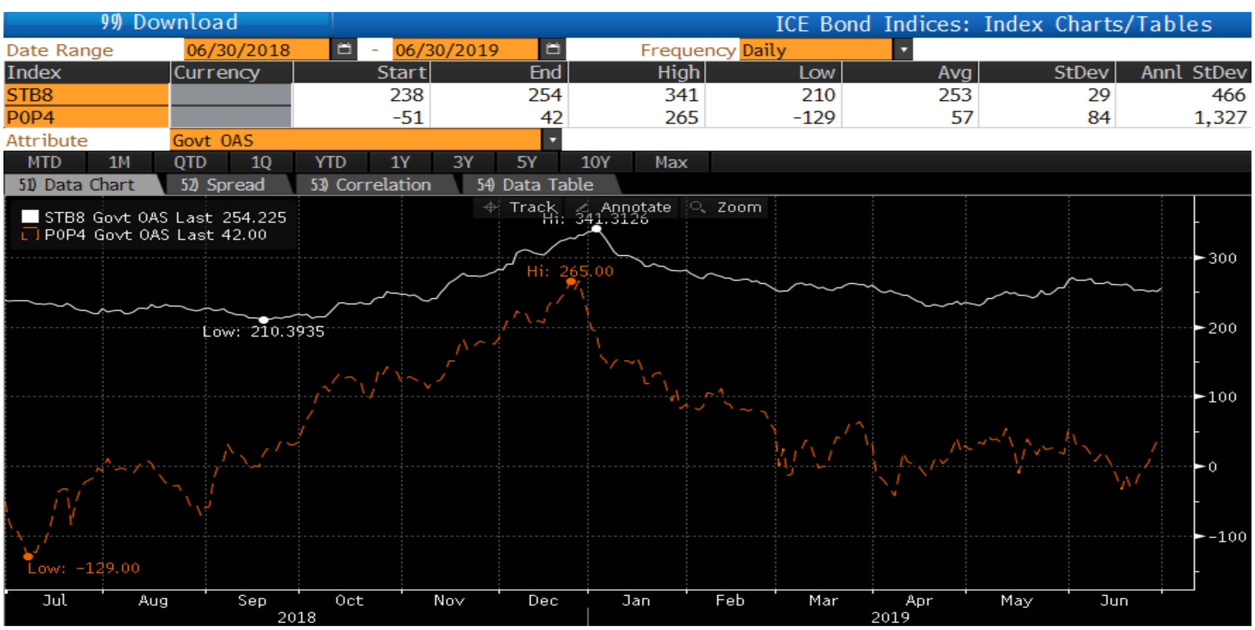
The ICE BofAML Large Cap Contingent Capital Index (***cocl***) rose 3.38% to close yielding 4.74%, which was 79bps lower than last month. The rebalancing this month added 2 issuers to the head count and face value increased by $1.84 billion. The impact from the rebalancing increased the yield-to-worst by 5bps to 4.79%. A **"contingent capital security"** (i.e., a "CoCo") represents a capital security issued through indenture typically within the context of a "<u>going-</u>

concern" type regulatory regime for banking, which would reorganize an insolvent bank through the contracts of its capital before falling into any conservatorship. CoCos payments are non-cumulative and pari passu to common stock dividends and can be reduced or eliminated without causing an event of default. Principal loss absorption on a CoCo could be forced ex-ante through a regulatory action in advance of any bankruptcy proceeding (note that an actual bankruptcy may not happen because enough loss absorbing bail-in capital, including tier-2 capital, could be available through the "living will" of core capital).

Implications of Market Activity:

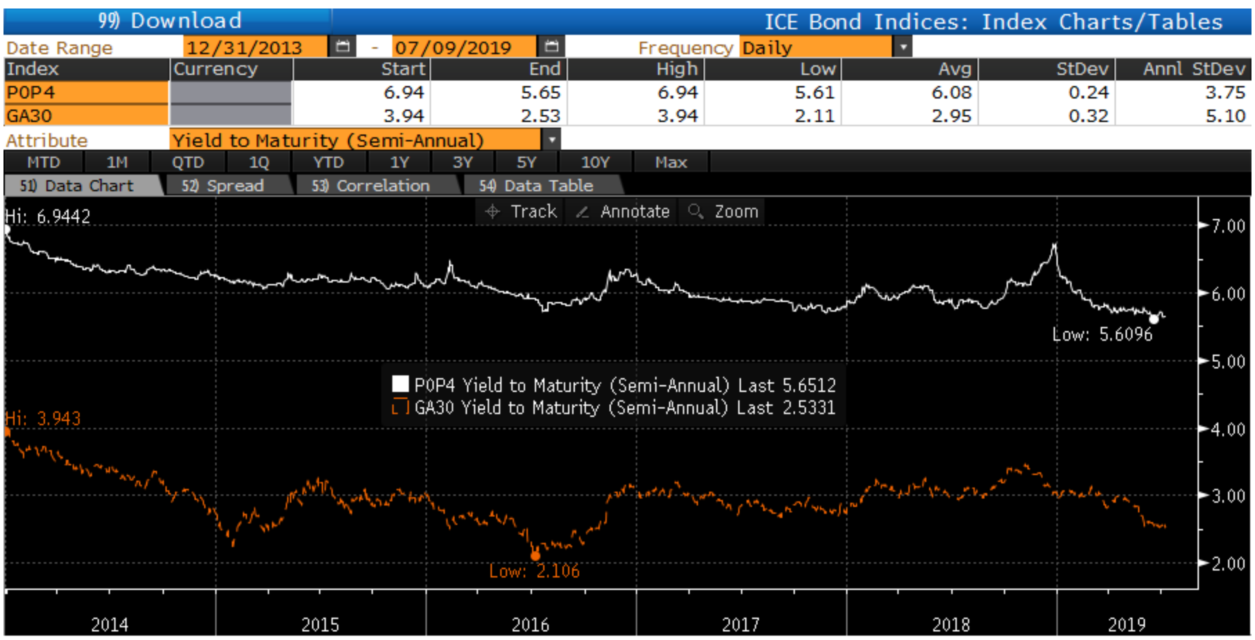
$25par Retail Preferred Securities Sector

The retail preferred securities sector rose $0.69 this month. The graph below shows spread in the $25par market (i.e., p0p4) over the past year compared to the spread in the $1,000 par institutional preferred securities market (stb8), which as a group we'll refer to as "NoCos" to distinguish $1,000 preferred securities from $1,000par contingent capital securities risks.



Source: Bloomberg

Option adjusted spreads in the retail sector dipped below zero again in June with the voracious yield grab from money flows into the sector. The passive preferred securities ETFs saw steady inflows in June and closed the month at the high share counts for the year. The money flows have recovered half of the total record outflows of last year while prices have fully recovered their losses rising back to last summer's high. Indeed, the exuberant behavior of equity prices and defacto easing conditions of sovereign prices has lured retail into buying down yield into the prospect of more central bank asset purchases and fear of even more income repression. The graph below shows the yield-to-maturity in the $25par sector (i.e., ignoring the call risks) in a long trend to lower yields since the end of the taper tantrum(2013) – in fact, this month marked an all-time historic low running yield for the $25par sector:

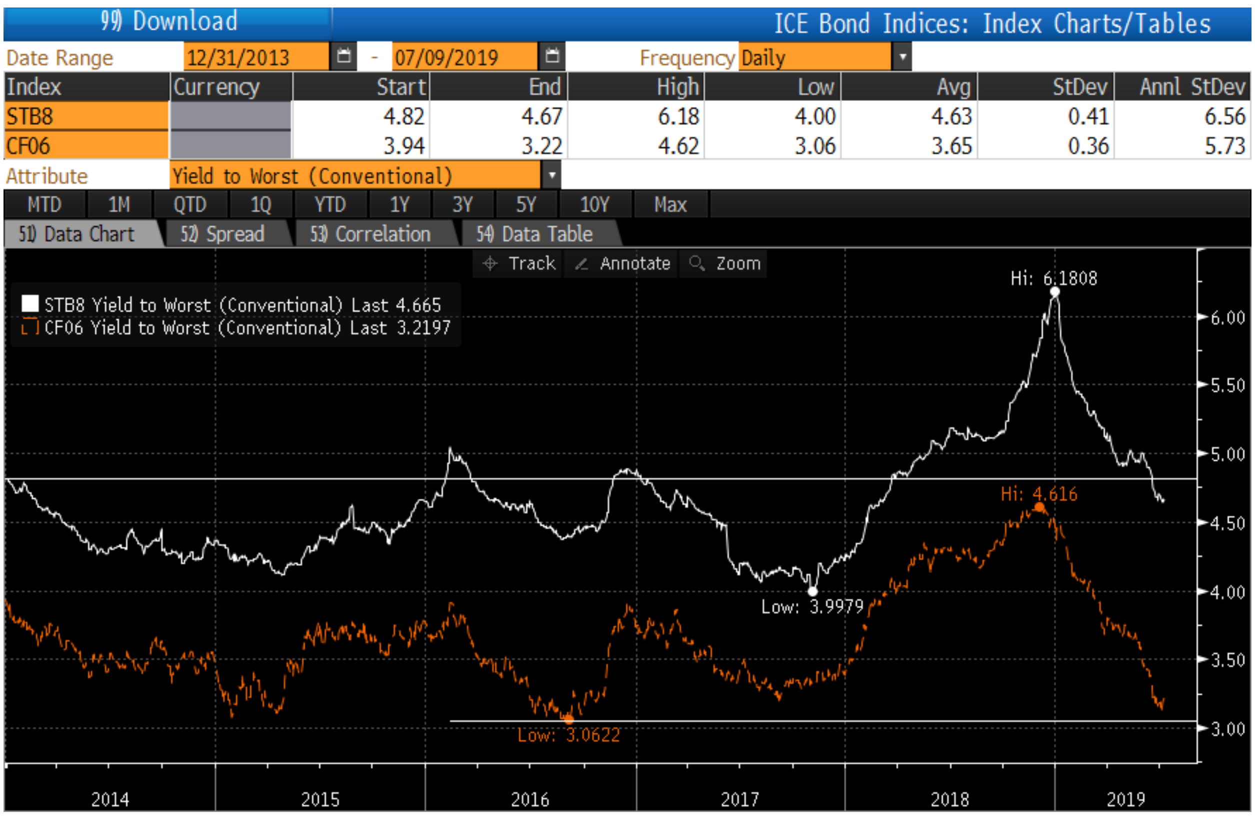


Source: Bloomberg

Given yields are at all-time lows in the retail sector, it is surprising that issuance wasn't flowing like a fire hose in June. There were, nonetheless, a few opportunistic and recognizable issuers into the retail sector this June – for example, Bank of America (5.375%), Voya Financial (5.35%) and Sempra Energy (5.75%).

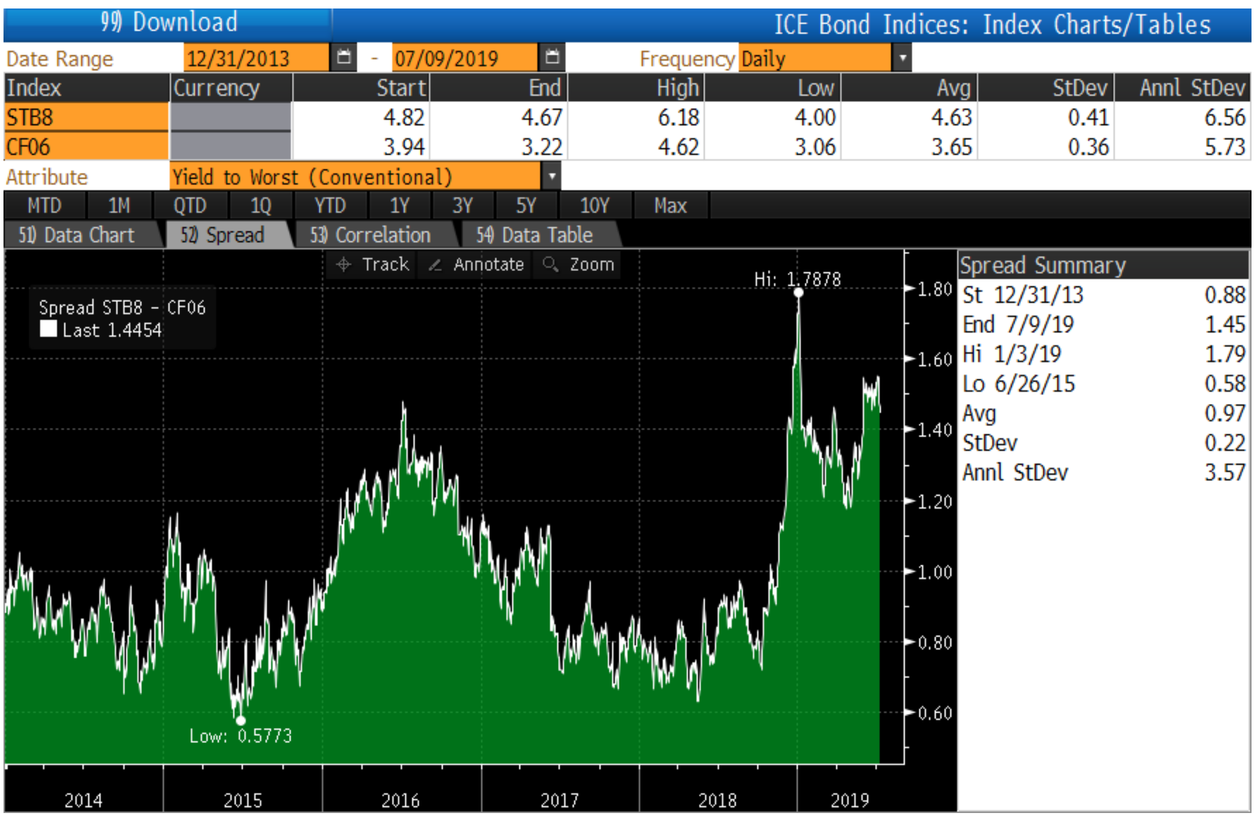
<u>$1,000par Institutional Preferred Securities Sector</u>

The $1,000 par institutional sector of the preferred securities rose $1.80 this month, more than twice as much as the retail sector as there is less in-the-money call option resistance for the institutional sector and 175bps of additional spread. The chart below shows the yield-to-worst of NoCos (i.e., stb8) vs. US Financials, 5-10yr (i.e., cf06) since 2013:



Source: Bloomberg

Yields on NoCos are 18bps lower than they were just after the taper tantrum, which breaks a 14month streak of being higher than 4.82%. As junior subordination is a relative-to-senior game, it is always instructive to compare yields to the more senior US Financials benchmark (i.e., cf06) – note that yield in this senior sector has dropped close to its low since the taper tantrum, while preferred securities still have almost half the field to run. So, the primary story for NoCo preferred securities continues to be one of relative value compared to senior paper. The graph below shows relative spreads in NoCo's compared to senior financials is 2.2 standard deviations higher than average and still higher than differentials in 2016 when we had the wides in absolute spreads for the cycle. In other words, NoCo spread premiums are more attractive (still) relative to senior financials than they were when spreads were at their absolute wides in 2016.

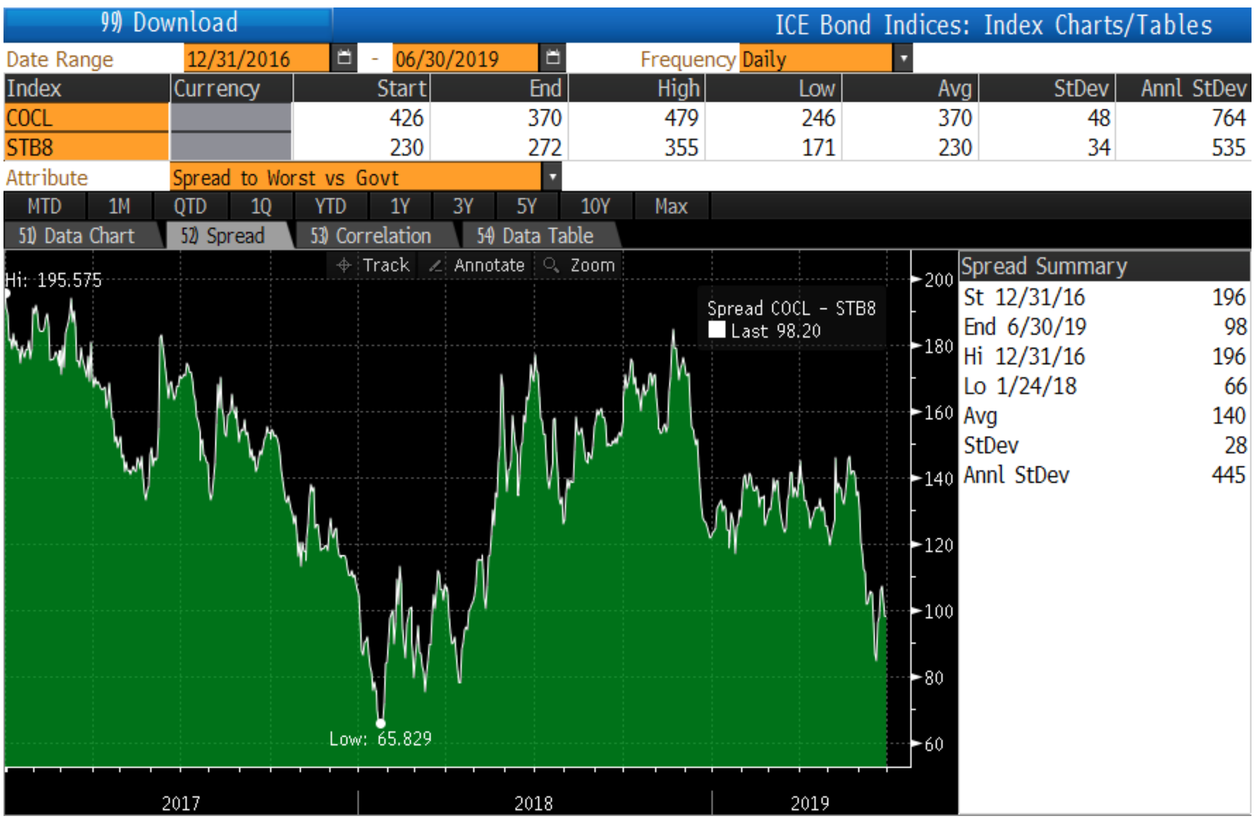


Source: Bloomberg

The trade here is to buy NoCos and sell senior financials as a play on yield compression in quality financials in anticipation of central bank punch bowls being served again to prolong the expansion. So, if one may have missed some of the rates move or some of the spread duration gains, institutional preferred securities could be a way to gain some ground on the broader benchmarks in credit.

Contingent Capital Securities Sector

The CoCo sector increased $2.92 this month against the backdrop of a choppy/ bottoming behavior in European bank equity shares. The graph below shows the spreads in CoCos (i.e., cocl) relative to the spreads in NoCos (i.e., stb8) over the past 2yrs:



Source: Bloomberg

The spread differential between CoCos and NoCos tightened 37bps month, which brings the differential 42bps below the average differential since 2016. Growth in Europe is still sluggish and anecdotes of companies like BASF in Germany are tempering outlooks. Consequently, policy makers are stepping up their game with dovish talks. For example, ECB Chairman Mario Draghi continues to push back on deflation concerns by professing that the ECB "still has considerable headroom" and that the central bank will "answer any challenge to price stability in the future". European markets have priced in an ECB cut of at least 10bps in the deposit rate in July. In addition, Chairman Draghi reminds us that QE can come again – especially if declining inflation risks purportedly from dwindling trade benefits become intolerable.

Outlook:

Central bank officials have turned considerably more dovish during June and are indicating policy adjustments are likely sooner than later – perhaps as soon as this month. We now believe that the Fed will make a 25bp cut this July as a prelude to more intellectual contemplations during the Jackson Hole 2019 Economic Symposium entitled, "Challenges for Monetary Policy", held the 3rd week of August. Given that the average length of no action on rates after a series of rate hikes by the Fed is 8 months, an "insurance cut" would have more value if done before the September meeting – and the markets are priced to demand it. So, the Fed appears now to have more to lose in not making a move especially given its growing concern for the outlook. The Jackson Hole conference should be very robust this summer and help to shape policy views on what tools beyond federal funds would be used to restore inflation confidence. In the past, balance sheet tools have been useful in moving up inflation results and are likely to be used again. This would add support to our base case that the Fed should start buying US Treasury Bills by selling notes (and bonds) to twist the yield curve; and perhaps even implement net new purchases to average down the duration of an expanding balance sheet next year.

- We expect the credit environment to be constructive as the Fed remains supportive of growth with no intention of inverting the yield curve and should take more immediate actions to steepen it.

- The combination of contained spreads, modestly higher longer-term US Treasury rates (if more QE comes) and attractive relative yield values should combine for a positive total rate of return for junior subordinated capital securities – especially for the institutional sector because nominal yields and spreads are higher than in the retail sector.
- The retail $25 par sector appears fully valued and needs a strong bull steepener to benefit spreads. We expect the retail paper to come under some pressure as a modest bear steepener develops once the rate cuts are absorbed this year and more QE comes into the conversation.
- NoCos are especially attractive in the relative; and CoCos appear to be a fair value

Phil Jacoby
CIO, Spectrum Asset Management
July 10, 2019

Spectrum Asset Management, Inc. is a leading manager of institutional and retail preferred securities portfolios. A member of the Principal Financial Group® since 2001, Spectrum manages institutional portfolios for an international universe of corporate, insurance and endowment clients, mutual funds distributed by Principal Funds Distributor, Inc., and preferred securities separately managed account solutions distributed by Principal Global Investors, Inc.